Social (in)security for all: Pension reform in Central and Eastern Europe

The reforms of the social security systems in Central and Eastern Europe (CEE) were not driven by a commitment to better compliance with international human rights standards, but rather by the trends of economic restructuring in these countries. For some countries like Poland, Hungary and Bulgaria, the reforms were more radical and the choice of social security reform paradigm was conditioned by the need for heavy debt servicing, and therefore negatively impacted by the World Bank 'assistance' for such reforms. The social and gender aspects of pension reform were systematically neglected as the ministries of finance were the main architects and actors of the reforms.

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The following critique of pension reform in Central and Eastern Europe (CEE) is based on the analysis and outcomes of research by economic experts who compared the two main paths of social security reform in the region (Mueller, 2003). It is further informed by a critical analysis of the World Bank policy in the region elaborated by independent experts.

An ageing population and the financial troubles facing public pension schemes, as well as a new wave of pension reforms in Latin America, triggered renewed debate about the need to reform old-age security schemes in Eastern Europe in the mid and late 1990s. The international pension controversy over whether to basically maintain a public pay-as-you-go (PAYG) system by adapting its technical parameters, or to implement a private, fully funded pension scheme such as the one introduced in Chile in 1981, brought about non-uniform paradigmatic choices in the countries of the region.[1]

The main factors behind the pension reforms in the CEE were structural: economic transformation, institutional factors and those related to the role of specific political actors. Although Pierson and Weaver (1993) and other economists and political scientists advocate a cautious retrenchment rather than a fundamental regime change in old-age security, in cases of severe demographic crisis, the reforms in the CEE countries showed that a radical paradigmatic change is possible.

But were these changes driven by the principle of social security for all?

The answer is provided by an analysis of the two main patterns of social security reforms followed in countries like Poland, Hungary and Bulgaria, on the one hand, and the Czech Republic, Romania and Slovenia, on the other. These two groups of countries are representative of the two approaches taken to pension reform in CEE, with the rest of the countries being more or less aligned with one of the two.

The two models will be further analyzed through the example of countries representative of each: Poland and Hungary in the first case, and the Czech Republic in the second.

The legacy of the socialist pension system and post-socialist challenges

Pension systems in socialist CEE had reached virtually universal coverage in the 1960s and 1970s, and were marked by a number of other characteristics: they were organized as one-pillar public systems not separated from the state budget or other branches of social security, allowing for different forms of cross-subsidizing; employers' contributions were the only source of financing; the contribution-benefit link was weak; contributions were not registered on an individual basis; and wages from only a small number of working years were considered as relevant earnings. In general terms, both pension differentiation and average benefit levels were low. The retirement age was also comparatively low, typically 60 years for men and 55 for women.

The economic transformation affected the existing PAYG systems in a number of ways. Rising expenditures for old-age security were the result of the shift from indirect to direct transfers that were needed to counteract the erosion of real pension value related to adjustment-induced inflation and to the drastic reduction of subsidies on basic goods and services. On the other hand, the restructuring of state-owned enterprises had an impact on both the revenue and expenditure side of public pension schemes. The privatization, downsizing and closing down of enterprises was accompanied by a mounting number of disability pensions and early retirement policies. The latter brought about an increased number of pensioners and a falling number of contributors to the scheme, which resulted in a continuous deterioration of the system dependency ratio of existing old-age security schemes.

The pension crisis in the late 1990s was brought about by the economic transformation and was not linked to the ageing of the population. The existing old-age security systems had to be reformed both to restore their financial sustainability and to adapt some of the previous design features to the new economic order. At that point it was obvious to experts that the essential reform measures needed included the following: abolishing privileges, introducing employees' contributions, separating pension schemes from other social insurance plans, raising the retirement age, and restricting easy access to early retirement and invalidity pensions. Other, more controversial measures consisted of the separation of pension schemes from the state budget and strengthening the link between contributions and benefits.

Restructuring in Poland and Hungary was not radical enough to restore the financial sustainability of the public pension schemes, and so despite the high contribution rates, their old-age security schemes are dependent on state subsidies. In these countries many of the necessary reform measures, such as raising the pension age and the abolition of privileges, have met with considerable political resistance or have even been blocked by constitutional courts.

By contrast, the restructuring of the public pension scheme in the Czech Republic has contributed to a stabilization of its financial situation, and in the first years after the reform, it was running a surplus of 0.3% of GDP. It should be noted, however, that the differences regarding the financial situation of public pension schemes in Poland, Hungary and the Czech Republic cannot be explained only by the respective extent of PAYG reform. The Czech Republic had the advantage of a more favourable situation in the local labour market, while Poland and Hungary faced a far more drastic decline in the number of contributors to the public pension scheme.

Another reform step, the first move towards pluralization of pension provision schemes, was far less controversial. For example, in Hungary and the Czech Republic, supplementary old-age security institutions – private fully funded pension funds on a voluntary basis – were created in 1994 and a reasonable percentage of the labour force joined these funds. In both cases, a government incentive for participation was provided: a direct government subsidy in the Czech case, and a tax credit in the Hungarian case. More radical voices demanding privatization of pension schemes emerged later in Poland and Hungary.

1 See also the chapters by Aldo Caliari and Fernando Cardim de Carvalho in this Report.

Pension system reform in Poland and Hungary: the implications of the paradigm choice

Two major conflicting views on pension reform can be identified. On the one side, in line with the traditional continental European pension paradigm, pension administrations, welfare ministries and many social security experts maintained that a radical regime change in old-age security was not necessary, since the reform of the existing public PAYG systems would suffice. To them, fully funded (FF) schemes were acceptable on a voluntary basis only. On the other side, the respective ministries of finance argued that a fundamental regime change was inevitable, and that a private FF pension scheme represented the only appropriate alternative to the financially unviable public old-age security system. This position essentially promotes the Chilean model. In order to overcome this fundamental division, small task forces were set up in both Poland and Hungary to work out a pension reform draft. They were actively supported by the World Bank, which – in the Polish and Hungarian context of high external debt – was able to play the role of a major external actor in pension reform with its internationally well-known stance.[2]

In both countries, the basic conflict between the ministries of finance and the welfare ministries about pension reform was settled in 1996 when a compromise was worked out by the respective task forces. This compromise was essentially a negotiated agreement between both sides with a bias towards the privatization faction.[3]

Thus, in both Poland and Hungary, the new pension system is a mixed scheme, combining a mandatory public PAYG pillar with a partially mandatory FF system.

The first pillar – the PAYG tier – is financed by employers' contributions and part of employees' contributions, and is mandatory for everybody. The public pension scheme will cover acquired pension claims by paying some sort of compensatory pension.

The second pillar – the FF tier – consists of a newly created pension fund system. Membership is mandatory for young people, as a complement to the first tier. While joining a pension fund was made mandatory for all new entrants to the labour market in Hungary, everybody under 30 years of age was required to do so in Poland.

Although the models in Poland and Hungary are strikingly similar, they differ in many aspects, particularly in the range of first-year reforms. For example, Polish reform plans for the first PAYG tier are much more radical.

Given that the privatization of old-age security is only partial, the Polish and Hungarian reforms are not identical replications of the radical Chilean pension reform, but instead resemble the Argentine model. The mixed model followed in Argentina has considerable political economy advantages over the full privatization of old-age security. For instance, the mandatory pension fund pillar is being built rather slowly, and this 'slow track' approach seems more appropriate in the light of the still fragile capital market and high inflation in CEE in the early years of the reforms. Meanwhile, employers' contributions are maintained to finance the obligations of the public scheme, even if the respective employee chooses the FF pillar. Maintaining employers' contributions also complies with the demands of trade unions.

Nevertheless, partial privatization does not avoid all of the pitfalls of the Chilean model. Besides the fact that CEE capital market risks are considerable due to the recognition of existing pension claims,[4] the mixed model can have significant secondary effects which can shrink the PAYG tier as contributions will increasingly be drained away, making the public scheme even more unsustainable fiscally and politically. This implies, according to some experts, that from the medium-term perspective, the mixed model is biased towards a gradual phasing in of the Chilean model.

As a general observation, public pension systems in Poland and Hungary ran deficits which had to be covered by the state budget. In this context, pension system reforms had nothing to do with social policy, and instead, they served to strengthen the position of the ministries of finance. It is not surprising that the Polish and Hungarian pension reforms included a partial switch to a FF scheme, considering that the ministry of finance in both countries basically consisted of neoliberal economists interested in the macroeconomic advantages attributed to the switch to a funded system. Furthermore, the influence of the World Bank was facilitated by both countries' severe external debt problems. Basically, the World Bank was looking for a radical pension reform precedent in CEE, and it succeeded.

A contrasting case: pension reform in the Czech Republic

Contrary to Poland and Hungary, in the Czech Republic the choices made in old-age security reform have been well within the boundaries of the continental European welfare paradigm. The old-age security system consists of two main tiers: a public mandatory PAYG scheme that has been reformed and is running a surplus, and a voluntary private funded system established in 1994, instead of the mandatory one suggested by the World Bank.[5] The World Bank has not had much opportunity to influence the Czech pension reform process since the country's debt problem was considerably smaller than in Poland, Hungary and Bulgaria. The Czech model shows that countries in CEE can successfully diverge from the World Bank model and hence from the highly touted Latin American role model.

The missing gender dimension

In the early years of pension reform in the three countries considered above, gender equality was overshadowed by other concerns that were seen as more pressing, especially the fiscal and macroeconomic framework. Criteria for early retirement were liberalized for both women and men, retirement ages were increased, and pensions were made more individualized and earnings-related. Women entered the period of the reforms with the privileges from the socialist years but also with the inherited gender pay gap and the consequences f the gender segregation of the labour market. However, these inequalities were not analyzed prior to making decisions about the reform paradigm.

In addition, the reforms undertaken in the region tended to eliminate redistribution towards low-income workers in both the public and private pension schemes, which has a greater negative impact on women. Moreover, the partial privatization of pension schemes which took place in Hungary and Poland, as well as Bulgaria, raises a major issue concerning the size of men's and women's pensions as a result of their different average life expectancies. Under the private pension schemes adopted, the use of gender-specific tables leads to lower monthly benefits for women because their savings must, on average, be stretched to cover a longer lifetime.

2 The influential World Bank pension reform proposal basically consists of a three-pillar model of old-age security: a mandatory public pillar with the limited aim of poverty alleviation among the elderly; a mandatory private fully funded pillar linking benefits to costs actuarially; and a voluntary savings pillar. Within this framework, the lion's share of old-age security falls to private pension funds.

3 The Hungarian pension reform laws were passed by parliament in July 1997 and came into force on 1 January 1998, whereas in Poland the reform was scheduled to take effect in 1999 after the relevant legislation had been passed by the Polish Sejm in mid-1997 and late 1998. At almost the same time, pension reforms based on the same approach were initiated in Bulgaria, where the World Bank played the same role in imposing its reform model.

4 The fiscal burden caused will be substantial, since almost 100% of the economically active population was insured in the past.

5 In this way, the Czech government decided to give the emerging local financial market time to cope with the influx of pension capital by lowering its amount considerably.

WORLD BANK INDEPENDENT EVALUATION GROUP (IEG) CRITICISMS OF THE WORLD BANK PENSION REFORM MODEL

Critique of 'multi-pillar' reforms

The World Bank's model of partially privatized pensions, known as 'multi-pillar systems', has resulted in lower benefits for retirees, in part because of extremely high administration costs for the private accounts that the Bank encouraged, and in stagnant or even declining levels of pension coverage, despite the Bank's claim that coverage would increase with the reforms. In addition, the fiscal cost of diverting contributions away from public pensions into the mandatory private funds favoured by the Bank frequently leads to pressure to reduce spending on other public services.

Despite the rhetoric, the World Bank ignores the gender impact of its pension reforms and does little to expand benefits to unprotected workers

Given the lack of attention that the Bank has paid to the gender implications of its reforms, it is not surprising to discover that they have had a more negative impact on women than on men, a point that has been confirmed by the Bank's earlier study of pension reform in Latin America (World Bank, 2003). As for the Bank's claims that a primary motive of its interventions has been to increase pension coverage, the IEG concluded that in fact, "little support was provided to expanding old-age benefits to workers in the informal economy," and that "the impact of gender on the welfare of the elderly is assessed in only 11% of countries."

Claims about the positive impact of pension privatization on capital markets found to be unsubstantiated

Another World Bank claim over the years has been that privatization of public pension schemes contributes to a country's overall economic growth by stimulating the development of capital markets. The IEG report finds that the Bank had no factual justification for doing so, noting that it had generally ignored financial market conditions in the countries concerned and failed to evaluate the impact that pension privatization would have on financial markets. In other words, the Bank simply acted on blind faith in the magic of the market, since the IEG report concludes that "most capital markets have not developed significantly as a result of multi-pillar pension reform…"

There is no valid reason for forcing pensioners to subsidize private fund managers

It should be noted the World Bank's Latin American department came to a similar conclusion two years earlier, when it found, after examining comparative experiences in Latin America, that private managers generally proved to be very costly administrators and that "financial sector development can take place effectively in the absence of pension privatization."

The World Bank has a distinct bias towards privatizing public pension systems and more appropriate options have been ignored

After analyzing all of the pension reform loans granted by the World Bank between 1984 and 2005, the IEG notes that the Bank "has concentrated on multi-pillar systems rather than PAYG alternatives or non-contributory schemes … Median World Bank lending per country implementing second-pillar reforms was USD 50 million, compared with USD 7 million for those not implementing second pillars." The IEG report adds that in numerous countries "the Bank acted too quickly to support multi-pillar reforms … without examining options for complementary safety-net programmes to protect informal sector workers from poverty in old age."

Furthermore, the IEG observes that the World Bank encouraged several countries to engage in pension privatization even though their macroeconomic situation was highly unstable and government debt was high. For example, it found that the Bank encouraged multi-pillar reforms in 10 countries of Latin America and CEE where inflation was well in excess of 15%, and in four others where fiscal deficits were very high. Consequently, the Bank's reforms add increased pressure on public finances, as pension privatization "will temporarily increase the fiscal deficit because the government must continue to pay pension benefits while some contributions are diverted into private funds."

The IEG study also finds that the World Bank pushed ahead with pension privatization in several countries of CEE and Central Asia despite the fact that they "did not have sound financial systems" when they undertook the reform, thus adding to the risk that the private funds would be mismanaged.

Private sector corruption is ignored, technical assistance is inadequate, and high administrative costs are overlooked

The IEG report notes that the majority of countries where the World Bank sponsored pension privatization had poor corruption control indices, as calculated by the Bank itself. While the Bank claims to encourage regulation and supervision of pension fund managers and financial intermediaries, the report finds that the assistance provided in this area has been insufficient and identifies serious problems in the regulatory structures in several countries where pensions were privatized.

Unfortunately, the IEG report does not examine the problem of the high costs of administering private pension funds as compared to the public systems that the World Bank encourages countries to scale down. The report does no more than acknowledge that the privatized funds "have been criticized for high administrative and marketing costs."

The myth of private funds' immunity to demographic changes

The report mentions the World Bank's continued assertion that funded private pension schemes protect retirees against demographic shifts, whereas PAYG systems are vulnerable. It is disappointing that the IEG does not question this assertion by the Bank's pension experts, since it has been discredited for several years. In 2001, a report from the International Labour Organization (ILO) concluded that the impact of demographic ageing is similar on both types of regimes. ■

Source: World Bank Independent Evaluation Group (IEG), *Pension Reforms and the Development of Pension Systems: An Evaluation of World Bank Assistance*, Washington, 2006.

World Bank Independent Evaluation Group assessment confirms negative impact

The World Bank has been a major player in pension reform in developing and transition countries for more than two decades. Since 1984, it has granted more than 200 loans to assist pension reform in 68 countries. The publication by the World Bank's Independent Evaluation Group (IEG, 2006) of a major and largely negative assessment of the Bank's work on pension reforms constitutes an important vindication of the criticisms and recommendations for change to the Bank's pensions policy made by trade unions around the world, and specifically in relation to the leading role of the World Bank in designing and implementing pension reforms during the 1990s in Latin America and CEE. Trade unions have asserted that the World Bank could play a useful role by assisting countries to make their public pension systems fully assume their role by increasing coverage of those excluded and by modernizing their administration. Instead, the model promoted by the World Bank has created and exacerbated inequalities.

A statement prepared by Global Unions for the annual meetings of the World Bank and IMF in September 2005 summarized the kind of role that the World Bank could play in improving pensions systems:

> Old-age pension systems do face important challenges in many countries. A starting point for establishing a new system or reforming an existing one must be that any changes to the pension system should be designed so as to improve the system for workers and retirees, not to prioritize unrelated goals such as forcing retirees to give up part of their pension benefits to inefficient private-sector administrators on the pretext that this will help the financial services industry develop. In 2001, the International Labour Organization's annual conference adopted a tripartite consensus on several points concerning the future of social security, including giving highest priority to the extension of those not covered and strengthening, rather than weakening, solidarity systems. The World Bank would do well to revise its own role in conformity with the ILO's consensus when intervening on the theme of old-age security.

All of these deficiencies imply the need for a major revision of the World Bank's approach to and support for pension reform, which also means a revision of the paradigm of social security reforms in the CEE countries that followed this model. This has become even more imperative as countries around the world are recognizing that dismantling public systems and trying to replace them with partially or totally privatized schemes is a recipe for failure. ■

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